WILK & ASSOCIATES, INC.

EX PARTE OR LATE FILED

November 6, 1998

Ms. Magalie R. Salas
Secretary
Federal Communication Commission
1919 M Street, N.W., Room 222
Washington, DC 20554

Re: Advanced Services NPRM - CC Docket No. 98-147
Ex Parte White Paper Presentation

Dear Ms. Salas:

Attached are two copies of an *ex parte* White Paper prepared by Wilk & Associates, Inc. for consideration by the Commission in the above-referenced proceeding. Please include a copy of this letter and the attached material into the record in this proceeding in accordance with Section 1.1206(a)(1) of the Commission's Rules concerning *ex parte* communications. If there are any questions, please contact the undersigned.

Sincerely,

Carl R. Danner

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Promoting Advanced Services and Local Competition: A Better Approach to Section 706

G. Mitchell Wilk[1]
Carl R. Danner, Ph.D.
November 6, 1998

Executive Summary

The FCC believes that its Section 706 Notice of Proposed Rulemaking offers valuable new opportunities for local telephone companies to provide new advanced services to customers. Unfortunately, the FCC's proposal fails to deliver on that promise, and represents a step away from the pro-competitive, de-regulatory framework Congress sought through the Telecommunications Act of 1996.

Essentially, the FCC has told local telephone companies that they can offer advanced services free of stifling regulation only if they are not, in fact, local telephone companies -- but instead use a new kind of separate subsidiary more intensively regulated and separated than any the FCC has required before. This leaves local telephone companies with the choice of offering advanced services themselves under rules that let their competitors freely take the gains from successful innovation, or using the new and highly disadvantaged subsidiary as an outlet for advanced services that can benefit from none of the advantages that integration would create. The reaction of AT&T's Chairman, when faced with a similar proposed requirements, was to state: "No company will invest billions of dollars to become a facilities-based broadband services provider if competitors who have not invested a penny of capital, nor taken an ounce of risk, can come along and get a free ride on the investments and risks of others." Of course, there is no gain for customers in either denying local telephone companies the incentive to innovate, or foreclosing the cost savings and efficiencies that local telephone companies might create from making advanced services part of the local telephone company.

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This white paper lays out these concerns, and highlights the self-perpetuating nature of the regulation the FCC would now apply to advanced services. Instead of the NPRM's approach, the FCC should take a leadership role by declaring that unbundling and resale requirements will not apply to advanced services, and likewise that state efforts to apply those requirements will be preempted. Short of that remedy, the FCC should at least adopt GTE's National Advanced Services Plan to permit advanced services to be integrated with all other LEC subsidiary operations, and to reaffirm the soundness of the FCC's existing rules in this area – which have demonstrated no weakness or failing since their adoption.

Promoting Advanced Services and Local Competition: A Better Approach to Section 706

G. Mitchell Wilk[2]
Carl R. Danner, Ph.D.
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By now it should be clear that the appropriate interpretation of the "pro-competitive, de-regulatory policy contained in the" Telecommunications Act of 1996 s remains in full bloom for all concerned to tangle over, including all the intricate details about how it is to be accomplished. Perhaps this state of affairs was inevitable given all the interests that sought accommodation in the legislative process leading to the Act.

In any event, there is at least one ray of hope. In Section 706, the Act imposes an explicit duty on the Federal Communications Commission (FCC) to promote the deployment of advanced telecommunications services to all Americans. Thus, the Advanced Services proceeding provides a great opportunity for the FCC to use forbearance and *affirmative* deregulation to further the de-regulatory and pro-competitive objectives of the Act.

Unfortunately, paltry progress is evident in the FCC's Section 706 Order and Notice of Proposed Rulemaking (NPRM) (CC Docket No. 98-147), which do little to bring advanced services to all Americans, or to promote deregulation. Instead, the potential for incumbent telephone companies to offer advanced services has been placed in the same kind of regulatory box that has grown up around most activities of local exchange carriers (LECs) since the Act was passed. The NPRM essentially tells LECs they can be free to offer such services in a less-regulated manner so long as they are not LECs – that is, only through a separate subsidiary to operate under a new and uniquely restrictive set of rules proposed without any evidence that such increased burdens are necessary. Further, the NPRM would also impose a set of new and more

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stringent obligations on LECs with respect to their wholesale dealings with competitors.

What's wrong with this? We have two primary concerns. First, the FCC's framework would deny incumbent LECs the ability to innovate and benefit on the same terms offered to virtually every other company in our competitive economy. This implies that such LEC market participation will be little missed, a conclusion we believe is mistaken and unnecessary. Second, what this discussion really needs is a long-term strategy for achieving the pro-competitive and deregulatory goals the Act embraces, at least with respect to LECs and the markets they might contest. We believe we can articulate such a vision that makes sense not just for advanced services, but also for the public policy governing other aspects of LEC market participation. We would encourage the FCC to pursue such a vision itself, and also to reaffirm its own existing regulations that adequately oversee LECs.

In short, what is needed is a sensible exit strategy for regulation that is consistent with the Act's goals, and that is what we develop in this paper with respect to Section 706.

1. Elements of the FCC's Actions and Proposals

While many readers will be intimately familiar with the FCC's Order and NPRM, it is worth briefly reviewing their terms. Two factors spurred the FCC's actions. First, a number of Regional Bell Operating Companies (RBOCs) and some of their competitors filed petitions with the FCC seeking conflicting interpretations of the Act; principally, the RBOCs sought freedom from the Act's mandatory unbundling and resale requirements for advanced services such as ADSL, while the RBOCs' competitors sought affirmation that those requirements apply to such offerings. The non-profit Alliance for Public Technology also petitioned, seeking FCC actions to promote universality of advanced services. Second, as noted above, Section 706 of the Act required the FCC to open a proceeding to address the promotion of advanced services within 30 months of the Act's February, 1996 enactment.

In response to these petitions, the FCC essentially denied all relief sought by the RBOCs, while providing their competitors much of what they requested. Advanced services and the networks that provide them were declared subject to mandatory interconnection, resale and unbundling under the Act's terms. RBOC advanced services were likewise denied any relief from the Section 271 requirements that now prohibit RBOCs from providing interLATA services. The FCC also proposed a new option for LECs: The ability to offer advanced services free from unbundling and resale obligations if provided through a subsidiary subject to a new, highly stringent set of separation rules and requirements. Finally, the FCC proposed to expand its existing LEC requirements for unbundling and collocation in light of what the FCC saw as concerns raised by the provision of advanced services. In other words, LECs asked for regulatory relief, and were told that they could have such relief if they were not LECs.

2. What is the Problem the FCC is Trying to Solve?

What is really at issue in the Advanced Services proceedings? First and foremost, Congress is concerned about promoting innovation and the availability of advanced services -- that is why Congress wrote Section 706 into the Act. Second, at a practical level the FCC's Order and NPRM concern the specific role that LECs should have in the advanced services market, both as retailers, and also as wholesalers -- including whether LEC advanced services should be subject to compulsory unbundling and resale on terms set by regulation.

These policy questions are not new to the FCC, and have previously been seen to hinge on two countervailing concerns: Whether the integration of new services might permit or encourage anticompetitive conduct by LECs; and, whether LECs can achieve useful economies of scale and scope by integrating advanced services into their core operations. Those most concerned about improper conduct have favored handicaps, limits or outright prohibitions on LEC participation in new markets. Those who focus on scale and scope economies (including one-stop shopping opportunities for customers) have favored letting LECs go ahead to offer advanced services, as free of regulation as possible. Traditionally, there has been little hard evidence on which to

evaluate either of these concerns.

Perhaps as a result, the FCC has a long history of regulatory ambivalence towards LEC participation in new ventures. At times, the FCC has focused on anticompetitive concerns, as in its *Computer II* decision that mandated a separate subsidiary for enhanced services. At other times, the FCC has been more persuaded by the benefits of integration, as in its *Computer III* reversal permitting integrated enhanced services operations (albeit under cost allocation requirements that disadvantaged LECs that made the attempt). The FCC has also been muddled on the issue, as when it sought in its Telecommunications Act of 1996 *First Report and Order* to require LECs to "share" the benefits of network scale and scope economies with competitors through prices for unbundled network elements – as if a network could effectively be integrated and broken apart at the same time.

Admittedly, the Commission has wavered on the issue. And it has been – and it remains – difficult to assess the relative costs of integration versus the potential for improper conduct. Yet, few seem to doubt that integration would create benefits of at least some potentially significant magnitude. Thus, we are driven to ask whether a stable way can be found for customers to enjoy the benefits of integrated LEC provision of advanced services. The alternative is for the public interest in this area to be defined indefinitely by the shifting sands of these two competing concerns, and the political strengths of their proponents -- as is aptly illustrated by the relative lack of factual basis for most of the FCC's conclusions in this area, including the *Order* and the *NPRM,* but also earlier orders (and policy reversals) such as *Computer II* and *Computer III,* which seem to have spoken more to sentiment than empirical evidence. Surely, a long-term pro-competitive strategy for deregulation of the industry ought to rest on more substantial foundations.

This is the essential problem of Section 706. Rather than the latest round of see-saw political debate about the benefits of integration versus the potential for abuse, can a reasonable way be found for LECs to participate as full competitors in the advanced services marketplace -- even if

it may be argued (or presumed) that they retain some market power over local service? We think that such an approach can be found, and further, that the prospects for the ultimate deregulation of competitive local telephone service may depend upon public policy makers accepting the need for (and legitimacy of) such an approach.

3. The Impact of the FCC's Proposals on Incentives to Innovate

For its part, in the *Order* and *NPRM* the FCC provides *an* answer to how LECs might provide advanced services – under the full unbundling, interconnection and resale provisions of the Act. And, it is certainly possible that LECs may develop or offer some advanced services under these terms. But it also is obvious that this kind of regulation greatly diminishes the incentives for LECs to innovate, particularly where significant financial risk is involved. Indeed, it is difficult to identify any firm, or industry in the American economy that is more disadvantaged in efforts to innovate, and thereby profit, than LECs would be under these rules. Let us turn to the practical impact of what LECs face under the FCC's Section 706 ruling and proposals.

Under Sections 251 and 252 of the Act, incumbent LECs have the unique obligation to provide use of their services and networks (and pieces thereof) to their competitors at negotiated prices to be reviewed (and, in practice, actually set) by state regulatory agencies. Under the standards the FCC has promulgated and which states have generally applied, the wholesale prices (and/or avoided cost discounts) for their resold services or unbundled network elements (UNEs) are intended to represent regulatory agencies' notions of efficient, competitive forward-looking costs -- particularly for unbundled network elements. It is beyond dispute that regulatory agencies have tried to prevent LECs from making any economic profit through sales of UNEs, and have also tried to assure that wholesale discounts for resold services reflect all retailing costs that might be avoided.

Thus, competitors of LECs can pick and choose only those LEC facilities or services that are attractive, while ignoring the rest. And while some measure of LEC profit might be preserved

through resale of an already-profitable service, the UNE piece parts of the network itself are to be provided to competitors at prices set by regulatory agencies to cover some measure of production cost – but not contribution or profit from innovation. Competitors also have a make or buy choice regarding their own service offerings, and their incentives are to purchase from the LEC that which is priced below cost, while self-providing that for which the LEC charges a price that includes an attractive margin. These incentives clearly point towards LECs earning low margins for services or facilities competitors may actually purchase on a wholesale basis.

The problem is that the regulatory policies for wholesale pricing run precisely contrary to what law and economics recognizes as the incentive for innovation – the ability to profit, perhaps by a great deal, as the payoff for successful invention or innovation. Mandatory unbundling and resale greatly limit or even eviscerate that prospect, especially since competitors can pick and choose which new services or capabilities to buy from LECs on a wholesale basis.

Consider how mandatory resale and unbundling structure the innovation calculus for an LEC:

- It may invest its resources in an attempt to innovate, potentially spending significant sums up front before the results are known;
- Only some such attempts will succeed;
- The LEC may have an initial window to market the successful innovation to its customers, but
- Competitors will obtain the use of the innovation at cost-based prices or discounts (including little or no margin) once its market value becomes apparent.

Therefore, an LEC's opportunity to gain from an innovation (as it must if innovation is to be pursued) will be limited by the low-risk ability of competitors to appropriate the result for themselves – if it should succeed. Of course, attempts at invention, research and development also fail, and the cost of failure must also be recouped from the attempts that work. Is there no opportunity for LEC innovation under these terms? This we cannot say, for the relatively inexpensive (or the low-risk) effort might still pay off, since the LEC may retain the ability to

capture some gains even under these terms. But clearly, the unbundling and resale requirements render the profit incentive offered to an LEC vastly inferior to that which is offered to other firms and industries in our economy, as well as to the LECs' competitors in the same industry.

Indeed, the contrast is striking. For most firms and industries, a hierarchy of legal protections protect the right of companies to profit from their innovative efforts, even to the point of creating an artificial monopoly for the better part of a generation through a patent. For instance, public policy has long encouraged innovation in the United States, beginning with the Constitution's specific grant of authority to Congress to write patent and trademark laws:

> "The Congress shall have power...[T]o promote the progress of science and useful arts, by securing for limited times to authors and inventors the exclusive right to their respective writings and discoveries..." (Article I, section 8)

Of course, the common sense reason for patents is to provide incentives to those who would create useful inventions or innovations, incurring expense and risk in the process. While a patent does permit an inventor to earn monopoly profits for a defined period, those buying the patented product gain through using an innovation they otherwise might not have obtained.

Other public policy also protects innovations, to varying degrees. Copyrights provide long-lasting exclusivity to creators of literary or artistic works. Exclusive trademarks or servicemarks protect investments in brands and related defining characteristics of how a product or service is provided. Firms can also protect sources of competitive advantage as trade secrets, or through non-disclosure contracts courts will enforce. And even absent any of these specific legal protections, firms ordinarily have no affirmative duty to disclose or share particular sources of competitive advantage they may develop, including innovations in products or processes.

The law also meshes well with the teachings of economic theory and research. While the study of innovation is a huge subject encompassing many topics, across this literature the need is unquestioned for innovators to capture (or "appropriate") at least a portion of the benefits from

their successful efforts, in order to encourage innovators to put forth the effort and assume the risks. Nor is there any doubt about the importance of innovation to the American economy, where the majority of the measured improvement in the standard of living in this century has come from "the application of new, superior production techniques by an increasingly skilled work force."[3] The role of large firms or monopolies in innovation has also been long debated, without a definite answer; some evidence and theory points to highly concentrated industries as more innovative, while other evidence and theory points the opposite way. However, in summarizing this literature, Scherer and Ross conclude,

> "What is needed for rapid technical progress is a subtle blend of competition and monopoly, with more emphasis in general on the former than the latter, and with the role of monopolistic elements diminishing when rich technological opportunities exist."[4]

These ideal conditions sound very much like today's telephone industry, where both established, large players and innovative newcomers have opportunities and a role to play. Certainly, the economic literature – much less the history of the telephone industry itself, starting with Bell Labs – stands firmly against any claim that firms like incumbent LECs have nothing to offer by way of innovation. Therefore, any public policy that substantially limits the incentives of LECs to innovate is inherently suspect. Under the FCC's Section 706 approach, however, an LEC's *competitors* are given the right to appropriate the gains from any local telephone company innovation that proves successful -- *which turns the entire logic of patent protection on its head.* As a result, local telephone companies are effectively being told not to bother with efforts to develop any but the most certain, or costless of new technologies and products, even while Congress has singled out advanced services as requiring special efforts for promotion by the FCC.

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[3] Scherer, F.M. and David Ross. Industrial Market Structure and Economic Performance (3rd Ed., Houghton Mifflin Company, Boston, 1990), pages 613-614. See, generally, chapter 17 for a review of the economic literature on market structure, patents and innovation.

[4] *Id.*, at 660.

As a reality check on these concerns, we need look no farther than the recent comments of AT&T Chairman C. Michael Armstrong, whose firm is attempting to acquire the cable television giant TCI – including its unique, broadband connections to tens of millions of households. TCI's facilities provide the perfect base for offering many advanced services; however, other concerned parties have asked that AT&T–TCI be required to comply with unbundling requirements that would also permit competitors access to those facilities. Mr. Armstrong's response was quoted as follows:

> Mr. Armstrong said that the post-merger AT&T–TCI will be spending close to $2 billion to upgrade TCI's network to enable the company to offer a bevy of high-speed broadband services, such as Internet access and Internet protocol-based local telephone service. Other telecom companies should not be given a "free ride" on that investment, Mr. Armstrong said. That could dry up financial resources AT&T–TCI will need to complete their plan and also hinder competition, he warned. "No company will invest billions of dollars to become a facilities-based broadband services provider if competitors who have not invested a penny of capital, nor taken an ounce of risk, can come along and get a free ride on the investments and risks of others," Mr. Armstrong said. [5]

For the first time since the Act, its acquisition of TCI forces AT&T to face the potential consequences of a regulatory regime like the FCC proposes for the identical offerings of LECs (who, not incidentally, will presumably no longer have any advanced services "bottleneck" to speak of in locations where AT&T completes its planned network upgrades of TCI's plant). Not surprisingly, Mr. Armstrong's analysis of the resulting harm mirrors our own.

4. Regulatory Concerns and the Separate Subsidiary

Of course, proponents of the FCC's proposal might object to our analysis, offering reasons such as the following:

- First, that LECs are not especially innovative, and that their related efforts might be little missed;

[5] TR DAILY, November 2, 1998, page 2.

• Second, that the risks of LEC provision of new services are high, because LECs will thereby leverage local service monopolies into competitive markets for advanced services, to the detriment of competition and captive customers (who might be forced to pay cross-subsidies to fund such efforts);

• Third, that LECs can just as well innovate through a separate subsidiary, since there is little about advanced services that would benefit from sharing the existing LEC network, or the LEC's operational support and marketing functions;

• Fourth, that regardless of federal regulatory efforts, state authorities will extend a blanket of regulation over any advanced service that is integrated with the LEC (including resale and unbundling requirements), so freedom from federal regulation would be largely symbolic;

• Finally, that other regulatory constraints on LECs (such as rate of return regulation, or implicit ceilings on earnings) might themselves dull incentives to such an extent that any Section 706 initiative is effectively irrelevant.

We believe there is an appropriate response to each of these concerns.

A. If Permitted, LECs Will Produce Innovations

First, notwithstanding their status as once-monopolies, we have seen LECs improve their networks, reduce their costs, introduce and successfully market new products, and generally maintain a telephone system that we believe remains the envy of the world. We have no doubt that competition is preferable to monopoly, and that any large organization or business may have opportunities to improve. At the same time, we believe the evidence shows that worthwhile contributions can be expected from the nation's incumbent local telephone companies in the areas of innovation and deployment of advanced services. Indeed, the economics literature to which we referred also recognizes the potential shortcomings of highly-concentrated industries, or even monopolies; yet in fact (as theory allows), such industries have been the source of important innovations, including all that the Bell System produced as part of the foundation of modern telecommunications.

Other infrastructure providers – such as cable television companies – also have ubiquitous networks that can be capable of offering advanced services such as high-speed Internet access. For example, cable modems can offer much higher rate Internet access than the dial-up modems now typically used for Internet access over LEC loops. Indeed, in many instances another infrastructure company that is not handicapped by LEC-type regulation may be positioned to become a dominant provider, to the disadvantage of customers if LECs are hampered by regulation in their ability to respond.

While it is not possible to make a specific prediction as to the improvements to advanced services that LECs will make if unencumbered by regulation, we believe that public policy must recognize the likelihood that these major market participants will contribute, if allowed appropriate incentives to do so by regulation.

B. Existing Regulations and Incentives Already Address Concerns About Cross-Subsidy and Foreclosure of Access

Second is the issue of inappropriate conduct and cross-subsidy, or the assertion that gains from LEC participation will be exceeded by harms they will perpetrate on the market, and customers. Among many, it has seemingly become an article of faith that such abuses will occur, as evidenced by the knee jerk reactions from some competitors that decry any regulatory flexibility proposed for LECs. Such reactions also lead to a political dynamic that may be evident in the FCC's Section 706 proposals, whereby "concessions" to LECs are "balanced" by placing further limitations on LECs at the same time. In effect, the new proposed limitations reveal a puzzling inconsistency on the FCC's behalf regarding the existing oversight rules for LECs – which the agency has previously found to be adequate to the task.

The specific concerns with the market position of an LEC are cross-subsidy and foreclosure of access to unique facilities (or the network generally) needed by competitors to LECs. These are now decades-old concerns, with remedies that in many cases stretch back at least as far.

As for *cross-subsidy*, what is usually expressed is a fear that residential customers or interexchange carriers will overpay (for basic telephone service or carrier access, respectively) to support LEC incursions into new markets. However, since most LEC basic residential rates are still subsidized (or perhaps barely covering their incremental cost), describing them as a possible ***source*** of cross-subsidy is fanciful at best. Where LECs might increase basic rates, regulatory approval is still required, and almost always involves a highly contentious, public proceeding expressly aimed at preventing such cross-subsidy. For their part, while access charges still include a contribution (which is substantial in most jurisdictions), the undeniable trend of access charges is down, making increases for any purpose (including funding a new cross-subsidy) almost inconceivable. Further, state regulators and the FCC have rapidly adopted incremental cost analysis and modeling as the preferred approach to calculate service costs, which is a further safeguard against LECs sneaking improper costs into the equation. Nor do the majority of states or the FCC set large telephone company prices through rate cases any longer (or even through earnings "sharing" formulas); and the absence of rate-of-return regulation removes the means and the incentive for misallocation of costs – since the presumed motive for such efforts was to shift costs into regulated books of account (or between customer classes within regulated accounts) to increase the next earnings-based rate award from a regulatory commission. Of course, when prices are no longer set through a rate-of-return mechanism, this motive evaporates, as the Commission well knows. Finally, extensive federal and state accounting requirements and safeguards are targeted at misallocation of costs per se (even short of an actual cross-subsidy). Thus, we see no viable incentive or mechanism by which an LEC could perpetrate an improper cross-subsidy related to new advanced services.

We see three separate questions about potential *foreclosure of access*, which raise progressively diminishing public policy concerns:

- Ensuring interconnection between the networks of LECs and those of new competitors;

- Allowing competitors to make use of essential LEC facilities that could not reasonably be duplicated by a competitor;

- Requiring LECs to unbundle facilities or capabilities that may not be essential, but which competitors would find convenient.

For its part, the Telecommunications Act of 1996 requires that LECs provide interconnection to competitors, and also that they unbundle certain "network elements" for the use of competitors, and offer all "telecommunications services" for resale by competitors. In its Section 706 rulings, the FCC applied these provisions expansively, to fully encompass advanced services offered by LECs.

What are we to make of these expansive requirements? We think the FCC has gone too far, and has failed to draw the critical line between interconnection and unbundling of *essential* facilities and services, versus unbundling of *all* facilities and services.

As regards the first question, we believe the case for regulating interconnection between networks is clear, including a role for regulation if competing networks cannot agree on terms. The larger the number of customers who can reach one another, the more valuable is the assemblage of networks -- and this benefit also extends beyond the owners of any two networks that may be negotiating interconnection at a given time. This broader impact of any given LEC–competitor negotiation is a key distinguishing element of this concern, as is the fact that a competitor may have no ability to substitute anything else in place of interconnection with a given LEC. And requiring two network providers to interconnect does not necessarily deprive either provider of any innovation gains or profits it may obtain from offering advanced services to customers. We think the case for some kind of regulatory backstop is clearest here.

The second question involves unbundling of unique or "essential" facilities – those owned only by the LEC, not reasonably duplicable by competitors, and necessary to provide some kinds of service. Whether a particular facility fits this description is an empirical question that depends

upon whether viable alternatives are or could reasonably be available. For example, a local loop to a residential customer might be called essential if no other comparable facilities now reach that customer, although (for example) the availability of cable modems or wireless loops in a neighborhood would change that analysis.[6] Where a facility truly is essential, the case for allowing access to it at a fair price is clear.

Finally, the case is weakest – or, more precisely, nonexistent – for mandated unbundling of facilities that competitors already have or could readily duplicate or acquire for themselves. Indeed, the critical task for regulators is to distinguish carefully between those facilities that truly are essential and those that are not. The damage that would result from excessive unbundling is severe. Here, there is no externality, nor any LEC market power. Such a policy has not, to our knowledge, been applied to any other industry. When competitors can obtain facilities from multiple sources, there is no argument for mandatory resale or unbundling of embedded LEC plant.

For its part, the FCC has said yes to regulating all three levels with respect to advanced services and LECs – yes to regulating interconnection, yes to regulating unbundling of essential facilities, and yes to regulating unbundling and/or resale of all other LEC advanced services and related network elements. Even though the public policy justification for government involvement disappears as we move from interconnection and facilities that are genuinely essential to those that are not, the FCC has chosen to draw no line – but instead to apply the entire panoply of wholesale regulation, including its burdens on innovation, to all LEC investments, facilities and services.

[6] As noted above, the merger of AT&T and TCI will produce a competitor that is well-positioned to provide advanced services entirely apart from LEC facilities.

C. The Impaired Separate Subsidiary

As an alternative to applying full unbundling and resale requirements to LEC advanced services, the FCC has offered an option of creating a fully separated subsidiary to offer such services without those requirements. The FCC has also said that this subsidiary would be subject to new, additional affiliate transaction and separation requirements. Thus, existing LEC separate subsidiaries (such as GTE's long distance operations) would appear to be drawn under the new rules if they are to offer advanced services. The FCC has trumpeted this new subsidiary as a viable means for LECs to offer advanced services relatively free from regulation, perhaps even through a new network of the future. Of course, the usual suspects have also weighed in to decry the proposal as an unjustified capitulation to LEC interests.

In essence, this FCC proposal would permit LEC holding companies to provide advanced services under a kind of portfolio diversification, involving the creation of new business units that would have virtually nothing to do with the LEC's own operations. Indeed, as GTE has identified in its formal comments to the FCC, this new subsidiary would gain no apparent advantage from its association with the LEC, while also being placed in a worse position in its business dealings with the LEC than are the advanced services operations of competing carriers.

The question is what, if anything, this separate subsidiary proposal is likely to add to the advanced services market for the benefit of customers. From a public interest perspective, the new subsidiary would benefit customers only where it can add something that existing avenues for advanced services cannot. This question involves a tradeoff between (1) the gains to the new advanced services subsidiary from whatever association it is allowed to have with the LEC, versus (2) the business disadvantages and regulatory burdens imposed by the FCC's intensified affiliate transactions and separation requirements. Looking at the benefits side, all that's really in this for the new subsidiary is a potential source of equity funding, and the opportunity to share a common name with the LEC or its holding company. Any sharing of tangible assets, operations, or support services with the LEC is prohibited. On the costs and burdens side, the FCC's

proposals clearly raise the affiliate's cost of doing business with the LEC relative to what non-affiliates would incur for similar dealings. On balance, we believe the new subsidiary would lose more than it would gain, by comparison to the business standing of an unaffiliated advanced services operation.

To put this another way, consider a hypothetical investor considering an equity investment in an advanced services operation; his choice is between advanced services offered by a large, vertically integrated non-LEC, or a new subsidiary having a common parent with the LEC to be established under the FCC's proposed rules. We believe the investor would find the non-LEC operation more attractive; and if that is so, then *there is no benefit for customers or the economy in the FCC's proposal, since its new avenue would be clearly inferior to other opportunities that already exist to provide these services.*

The bottom line is that the only advantage of the FCC's proposal may be to permit the holding company to serve as a potential source of capital for funding the entry of a separate operation into a business in which many other firms already compete. Of course, there is no shortage of capital available for such purposes, and the cost of what the holding company might provide to its subsidiary would be no different than the cost of capital supplied from other sources for the same undertaking. Thus, there may be little that is special about permitting the separate subsidiary to offer advanced services under conditions that permit the use of holding company funding, but none of the other potential advantages LECs might bring to the effort. Indeed, the FCC's proposal is designed specifically to frustrate any such advantages, or joint efficiencies.

Finally, even putting the LEC aside, by creating special new restrictions on such an advanced services affiliate even by comparison to existing FCC affiliate separation requirements, the *Order* and *NPRM* could frustrate the achievement of joint efficiencies even with an LEC's existing subsidiaries and affiliates. We return to that issue below in addressing GTE's proposal in this proceeding.

D. Escaping the Briar Patch of LEC Regulation

A further argument for the FCC's proposal might be that any advanced services offered by LECs would inevitably fall under state jurisdiction, at least in part, and thus be regulated intensively regardless of the FCC's actions in the federal jurisdiction. Therefore, the FCC's proposal has offered LECs an avenue to avoid not just federal, but also state regulation by establishing a new advanced services subsidiary.

At this stage in the post-Act development of the industry, there is certainly some wisdom in observing that the path to any kind of deregulation of LECs (a goal envisioned by Congress) seems more remote than ever. The apparent desire for control and involvement on the part of regulatory agencies seems to reinforce the continual use of the regulatory process by competitors of all stripes to hamstring each other, or merely seek advantage through regulatory actions that may have been undertaken for some other purpose, but which cannot help but influence the relative competitive positions of numerous firms. Informed industry observers know that the "deregulation" that is reported in the popular press is a myth.

Notwithstanding this, we do not see the FCC's proposal as helping matters towards deregulation. Certainly the FCC has authority in the Act to preempt state regulation where appropriate, and the advancement of the explicit goals of Section 706 would seem to provide such grounds. If state regulation is the real problem, the FCC should try to preempt it directly rather than trying to force advanced services into a subsidiary -- which will probably require the protection of FCC preemption in any event if it is to stay free from state-level regulation.

Indeed, rather than protect LEC advanced services operations from problems caused by state regulation, the FCC's broad interpretation of unbundling and resale obligations is likely to prove a self-fulfilling perpetuation of that process. The prospects for competition and deregulation are harmed by mandatory unbundling and resale at government-set prices, if for no other reason than government is very unlikely to get those prices "right" – that is, set at levels equal to what a

competitive market would provide. Given the variety of network elements and services involved, and the varying cost and demand characteristics in play across markets, customers and geography, it is difficult to believe that government will even get some prices correct. This is not due to any lack of intelligence or effort in the attempt -- it is simply a truism of economics that government cannot substitute its centralized judgment for that of a market without causing substantial (even if inadvertent) distortions.

The problems that follow from wrong wholesale prices are easily seen. Competitors can make or buy their facilities, including from the ubiquitous LEC. Where government-mandated prices rise above market levels, they are of no consequence for the market -- entrants will either build facilities, or LECs will voluntarily offer wholesale prices below the regulatory ceiling. Where government-mandated prices fall below market levels, the make or buy decision is tilted towards purchasing LEC facilities at wholesale, thereby suppressing facilities-based competition. Even though other factors come into play (such as preferences for end-to-end control, avoiding regulatory risk, or minimizing sunk costs that might be stranded), below-market prices for LEC wholesale offerings must chill facilities-based competition.

Below-market prices for LEC wholesale services and facilities also create quasi-rents (or positions of privilege) for those competitors that purchase them. Under these circumstances, there is always a winner and a loser when an LEC and a competitor sign a contract; of course, normal business dealings proceed when both parties see advantages from a contract. Mandatory "win-lose" contracts are an obvious spawning ground for disputes that regulatory agencies will be called upon to resolve – leading to permanent regulatory involvement for as long as such contracts may be required.

Thus, below-market LEC wholesale prices create a virtual formula for perpetual regulation – on the one hand, a proliferation of forced contracts each involving one firm that gains at the other's expense, while on the other hand, potential alternative sources of supply are suppressed by low, regulated wholesale prices. If the presence of facilities-based competition is to be the test for

deregulation (as it seems to have become), then these circumstances offer no exit strategy for regulation.

Putting LEC advanced services under the same full regulatory umbrella as other LEC facilities and offerings will not advance the prospects for deregulation, and may well impair them.

E. The Impact of Other LEC Regulation

Finally, it may be argued that the choice of regulatory approaches to advanced services is of little consequence, since other regulation already greatly chills LEC incentives to innovate. In particular, the incentive problems of rate-of-return regulation are well known -- including the possibility that what LECs might gain from selling advanced services might thereafter be taken away in a rate case.

However, as of this writing alternatives to rate-of-return regulation are in use for large telephone companies in a clear majority of states, and at the federal level.[7] Even where rate-of-return regulation continues, competitive pressures facing local telephone companies may combine with the influence of regulatory lag to mitigate the effects of rate-of-return regulation, and thus preserve some of the payback to LECs from innovation.

Still, where the lingering impacts of rate-of-return regulation are a concern, the FCC should take advantage of the language of Section 706 and mandate that price caps (without earnings sharing) be used for any price regulation of advanced services at the state level, to preserve beneficial incentives. Better yet, the FCC should simply preempt such state regulation.

5. Conclusion: Two Proposals, and The Need for FCC Leadership

[7] "Status of Alternative Local Telco Regulation in the East," "Status of Alternative Local Telco Regulation in the West," State Telephone Regulation Report Vol. 15, Nos. 6-7 (March 20 & April 3, 1997); "Earnings Regulation For Big Incumbent Telcos Just About Extinct in Eastern U.S.," State Telephone Regulation Report Vol.16, No.7 (April 3, 1998).

As we have explored in this white paper, the FCC has essentially made a judgment call that the gains from integration of advanced services into LEC networks and/or operations are less than the chance that LECs would be able to use that integration as a source of anticompetitive leverage. Further, the FCC continues to appear comfortable with a highly regulatory approach to these questions that does not appear to contain an exit strategy for regulation; indeed, the opposite may be occurring as regulation becomes even more entrenched and self-sustaining. Not surprisingly, the current politics of LEC regulation also appear to play a role in the FCC's actions.

What are the alternatives? We would highlight two.

First, as was already implied by our analysis, a viable long-term approach to regulation of LECs should be minimalist and founded in genuine market failures, or comparable problems suited to a permanent regulatory solution. Further, as Congress stated in the Act, the FCC should hedge its bets on the side of competition and deregulation, not on the side of monopoly and regulation as it is doing today. As we have described, the centralized governmental regulation of unbundling and resale is self-fulfilling if the criteria for deregulation is the development of facilities-based competition, since that regulation will inevitably chill competition.

These criteria point towards the least possible regulation of unbundling and resale, since that will provide the most possible latitude for competition and deregulation. How can the FCC accomplish this? Generally speaking, the regulation of wholesale pricing (especially unbundling) should be limited to those facilities that are in fact essential in today's market, as we described earlier, and should otherwise leave LECs and their competition free to make whatever voluntary arrangements they may prefer for other wholesale transactions. Additionally, the FCC should recognize that regulated wholesale prices will inevitably be set incorrectly by regulatory decisions, and that the mistake the FCC should most want to avoid (in a pro-competitive approach) is prices set so low that they prevent competitive entry. Therefore, whatever prices

result from the current "combat-by-engineering-and-economic-models" of TELRIC brought about by the dictates of the FCC (as Alfred Kahn has aptly characterized the process) should gradually be increased to permit competition to develop based on appropriate price signals. If, in time, we discover that competition is infeasible for certain facilities or network elements for which there are still no realistic alternatives, it may eventually become necessary to re-regulate them as monopolies, as a last resort. But the FCC should first give competition a chance through regulatory forbearance.

Of course, this approach would include no wholesale regulation of LEC advanced services, since there is nothing "essential" about these new offerings. Likewise, LECs should be permitted to pursue the full benefits of integrating advanced services with their existing operations, since price caps and other protections against cross-subsidy will keep other prices from rising to fund such efforts. And while competitors to the LECs have a reasonable claim to regulated unbundling of *essential* LEC facilities, there is no justification for regulating the wholesale prices of other LEC services and facilities competitors can readily create for themselves. This pro-competitive, de-regulatory approach to advanced services will permit customers to obtain the benefits of integration, whatever those may be.

Second, we recommend GTE's National Advanced Services Plan if the FCC will not adopt an approach such as we have described. The GTE Plan represents a compromise with respect to the political pressures to which the FCC seem to be responding, while permitting some ability for LECs to obtain benefits from integration (albeit only with other subsidiary operations – not with the LEC). Further, GTE's Plan offers a one-time opportunity for LECs to transfer advanced services operations to a subsidiary free of regulatory burden or penalty, which would be a wise policy to avoid penalizing innovative efforts that LECs may have undertaken thus far. Neither is there any demonstrated need to adopt the more stringent separation requirements the FCC has proposed for an advanced services subsidiary, in the absence of any showing of harm or unworkability of the FCC's existing rules. The politics of LEC regulation are, in this case, a poor guide to informed policy, and the proposed harsher affiliate relationship rules seem to have

no other basis.

Finally, we would issue a call for leadership to the FCC. Obviously, the implementation of the 1996 Act has become something of a pro-regulatory muddle, and we suspect that most who were involved in its enactment hoped for more in terms of competition and deregulation by this stage. Much of the blame for these circumstances must be laid at the feet of regulatory agencies that have rhetorically embraced competition but continually hedged their bets by adopting intensively regulatory approaches to implementing the 1996 Act. As we have described here, such regulation can easily stifle competition and become self-perpetuating. Granted, there is uncertainty on every side of this debate, and particular results cannot be guaranteed -- but it is time for the FCC to cast its lot with the side of competition, rather than regulation, and this Section 706 proceeding provides the perfect opportunity to do so.

Promoting Advanced Services and Local Competition: A Better Approach to Section 706

G. Mitchell Wilk[1]
Carl R. Danner, Ph.D.
November 6, 1998

Executive Summary

The FCC believes that its Section 706 Notice of Proposed Rulemaking offers valuable new opportunities for local telephone companies to provide new advanced services to customers. Unfortunately, the FCC's proposal fails to deliver on that promise, and represents a step away from the pro-competitive, de-regulatory framework Congress sought through the Telecommunications Act of 1996.

Essentially, the FCC has told local telephone companies that they can offer advanced services free of stifling regulation only if they are not, in fact, local telephone companies -- but instead use a new kind of separate subsidiary more intensively regulated and separated than any the FCC has required before. This leaves local telephone companies with the choice of offering advanced services themselves under rules that let their competitors freely take the gains from successful innovation, or using the new and highly disadvantaged subsidiary as an outlet for advanced services that can benefit from none of the advantages that integration would create. The reaction of AT&T's Chairman, when faced with a similar proposed requirements, was to state: "No company will invest billions of dollars to become a facilities-based broadband services provider if competitors who have not invested a penny of capital, nor taken an ounce of risk, can come along and get a free ride on the investments and risks of others." Of course, there is no gain for customers in either denying local telephone companies the incentive to innovate, or foreclosing the cost savings and efficiencies that local telephone companies might create from making advanced services part of the local telephone company.

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This white paper lays out these concerns, and highlights the self-perpetuating nature of the regulation the FCC would now apply to advanced services. Instead of the NPRM's approach, the FCC should take a leadership role by declaring that unbundling and resale requirements will not apply to advanced services, and likewise that state efforts to apply those requirements will be preempted. Short of that remedy, the FCC should at least adopt GTE's National Advanced Services Plan to permit advanced services to be integrated with all other LEC subsidiary operations, and to reaffirm the soundness of the FCC's existing rules in this area – which have demonstrated no weakness or failing since their adoption.

Promoting Advanced Services and Local Competition: A Better Approach to Section 706

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November 6, 1998

By now it should be clear that the appropriate interpretation of the "pro-competitive, de-regulatory policy contained in the" Telecommunications Act of 1996 s remains in full bloom for all concerned to tangle over, including all the intricate details about how it is to be accomplished. Perhaps this state of affairs was inevitable given all the interests that sought accommodation in the legislative process leading to the Act.

In any event, there is at least one ray of hope. In Section 706, the Act imposes an explicit duty on the Federal Communications Commission (FCC) to promote the deployment of advanced telecommunications services to all Americans. Thus, the Advanced Services proceeding provides a great opportunity for the FCC to use forbearance and *affirmative* deregulation to further the de-regulatory and pro-competitive objectives of the Act.

Unfortunately, paltry progress is evident in the FCC's Section 706 Order and Notice of Proposed Rulemaking (NPRM) (CC Docket No. 98-147), which do little to bring advanced services to all Americans, or to promote deregulation. Instead, the potential for incumbent telephone companies to offer advanced services has been placed in the same kind of regulatory box that has grown up around most activities of local exchange carriers (LECs) since the Act was passed. The NPRM essentially tells LECs they can be free to offer such services in a less-regulated manner so long as they are not LECs – that is, only through a separate subsidiary to operate under a new and uniquely restrictive set of rules proposed without any evidence that such increased burdens are necessary. Further, the NPRM would also impose a set of new and more

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stringent obligations on LECs with respect to their wholesale dealings with competitors.

What's wrong with this? We have two primary concerns. First, the FCC's framework would deny incumbent LECs the ability to innovate and benefit on the same terms offered to virtually every other company in our competitive economy. This implies that such LEC market participation will be little missed, a conclusion we believe is mistaken and unnecessary. Second, what this discussion really needs is a long-term strategy for achieving the pro-competitive and deregulatory goals the Act embraces, at least with respect to LECs and the markets they might contest. We believe we can articulate such a vision that makes sense not just for advanced services, but also for the public policy governing other aspects of LEC market participation. We would encourage the FCC to pursue such a vision itself, and also to reaffirm its own existing regulations that adequately oversee LECs.

In short, what is needed is a sensible exit strategy for regulation that is consistent with the Act's goals, and that is what we develop in this paper with respect to Section 706.

1. Elements of the FCC's Actions and Proposals

While many readers will be intimately familiar with the FCC's Order and NPRM, it is worth briefly reviewing their terms. Two factors spurred the FCC's actions. First, a number of Regional Bell Operating Companies (RBOCs) and some of their competitors filed petitions with the FCC seeking conflicting interpretations of the Act; principally, the RBOCs sought freedom from the Act's mandatory unbundling and resale requirements for advanced services such as ADSL, while the RBOCs' competitors sought affirmation that those requirements apply to such offerings. The non-profit Alliance for Public Technology also petitioned, seeking FCC actions to promote universality of advanced services. Second, as noted above, Section 706 of the Act required the FCC to open a proceeding to address the promotion of advanced services within 30 months of the Act's February, 1996 enactment.

In response to these petitions, the FCC essentially denied all relief sought by the RBOCs, while providing their competitors much of what they requested. Advanced services and the networks that provide them were declared subject to mandatory interconnection, resale and unbundling under the Act's terms. RBOC advanced services were likewise denied any relief from the Section 271 requirements that now prohibit RBOCs from providing interLATA services. The FCC also proposed a new option for LECs: The ability to offer advanced services free from unbundling and resale obligations if provided through a subsidiary subject to a new, highly stringent set of separation rules and requirements. Finally, the FCC proposed to expand its existing LEC requirements for unbundling and collocation in light of what the FCC saw as concerns raised by the provision of advanced services. In other words, LECs asked for regulatory relief, and were told that they could have such relief if they were not LECs.

2. What is the Problem the FCC is Trying to Solve?

What is really at issue in the Advanced Services proceedings? First and foremost, Congress is concerned about promoting innovation and the availability of advanced services -- that is why Congress wrote Section 706 into the Act. Second, at a practical level the FCC's Order and NPRM concern the specific role that LECs should have in the advanced services market, both as retailers, and also as wholesalers -- including whether LEC advanced services should be subject to compulsory unbundling and resale on terms set by regulation.

These policy questions are not new to the FCC, and have previously been seen to hinge on two countervailing concerns: Whether the integration of new services might permit or encourage anticompetitive conduct by LECs; and, whether LECs can achieve useful economies of scale and scope by integrating advanced services into their core operations. Those most concerned about improper conduct have favored handicaps, limits or outright prohibitions on LEC participation in new markets. Those who focus on scale and scope economies (including one-stop shopping opportunities for customers) have favored letting LECs go ahead to offer advanced services, as free of regulation as possible. Traditionally, there has been little hard evidence on which to

evaluate either of these concerns.

Perhaps as a result, the FCC has a long history of regulatory ambivalence towards LEC participation in new ventures. At times, the FCC has focused on anticompetitive concerns, as in its *Computer II* decision that mandated a separate subsidiary for enhanced services. At other times, the FCC has been more persuaded by the benefits of integration, as in its *Computer III* reversal permitting integrated enhanced services operations (albeit under cost allocation requirements that disadvantaged LECs that made the attempt). The FCC has also been muddled on the issue, as when it sought in its Telecommunications Act of 1996 *First Report and Order* to require LECs to "share" the benefits of network scale and scope economies with competitors through prices for unbundled network elements – as if a network could effectively be integrated and broken apart at the same time.

Admittedly, the Commission has wavered on the issue. And it has been – and it remains – difficult to assess the relative costs of integration versus the potential for improper conduct. Yet, few seem to doubt that integration would create benefits of at least some potentially significant magnitude. Thus, we are driven to ask whether a stable way can be found for customers to enjoy the benefits of integrated LEC provision of advanced services. The alternative is for the public interest in this area to be defined indefinitely by the shifting sands of these two competing concerns, and the political strengths of their proponents -- as is aptly illustrated by the relative lack of factual basis for most of the FCC's conclusions in this area, including the *Order* and the *NPRM,* but also earlier orders (and policy reversals) such as *Computer II* and *Computer III,* which seem to have spoken more to sentiment than empirical evidence. Surely, a long-term pro-competitive strategy for deregulation of the industry ought to rest on more substantial foundations.

This is the essential problem of Section 706. Rather than the latest round of see-saw political debate about the benefits of integration versus the potential for abuse, can a reasonable way be found for LECs to participate as full competitors in the advanced services marketplace -- even if

it may be argued (or presumed) that they retain some market power over local service? We think that such an approach can be found, and further, that the prospects for the ultimate deregulation of competitive local telephone service may depend upon public policy makers accepting the need for (and legitimacy of) such an approach.

3. The Impact of the FCC's Proposals on Incentives to Innovate

For its part, in the *Order* and *NPRM* the FCC provides *an* answer to how LECs might provide advanced services – under the full unbundling, interconnection and resale provisions of the Act. And, it is certainly possible that LECs may develop or offer some advanced services under these terms. But it also is obvious that this kind of regulation greatly diminishes the incentives for LECs to innovate, particularly where significant financial risk is involved. Indeed, it is difficult to identify any firm, or industry in the American economy that is more disadvantaged in efforts to innovate, and thereby profit, than LECs would be under these rules. Let us turn to the practical impact of what LECs face under the FCC's Section 706 ruling and proposals.

Under Sections 251 and 252 of the Act, incumbent LECs have the unique obligation to provide use of their services and networks (and pieces thereof) to their competitors at negotiated prices to be reviewed (and, in practice, actually set) by state regulatory agencies. Under the standards the FCC has promulgated and which states have generally applied, the wholesale prices (and/or avoided cost discounts) for their resold services or unbundled network elements (UNEs) are intended to represent regulatory agencies' notions of efficient, competitive forward-looking costs -- particularly for unbundled network elements. It is beyond dispute that regulatory agencies have tried to prevent LECs from making any economic profit through sales of UNEs, and have also tried to assure that wholesale discounts for resold services reflect all retailing costs that might be avoided.

Thus, competitors of LECs can pick and choose only those LEC facilities or services that are attractive, while ignoring the rest. And while some measure of LEC profit might be preserved

through resale of an already-profitable service, the UNE piece parts of the network itself are to be provided to competitors at prices set by regulatory agencies to cover some measure of production cost – but not contribution or profit from innovation. Competitors also have a make or buy choice regarding their own service offerings, and their incentives are to purchase from the LEC that which is priced below cost, while self-providing that for which the LEC charges a price that includes an attractive margin. These incentives clearly point towards LECs earning low margins for services or facilities competitors may actually purchase on a wholesale basis.

The problem is that the regulatory policies for wholesale pricing run precisely contrary to what law and economics recognizes as the incentive for innovation – the ability to profit, perhaps by a great deal, as the payoff for successful invention or innovation. Mandatory unbundling and resale greatly limit or even eviscerate that prospect, especially since competitors can pick and choose which new services or capabilities to buy from LECs on a wholesale basis.

Consider how mandatory resale and unbundling structure the innovation calculus for an LEC:

- It may invest its resources in an attempt to innovate, potentially spending significant sums up front before the results are known;
- Only some such attempts will succeed;
- The LEC may have an initial window to market the successful innovation to its customers, but
- Competitors will obtain the use of the innovation at cost-based prices or discounts (including little or no margin) once its market value becomes apparent.

Therefore, an LEC's opportunity to gain from an innovation (as it must if innovation is to be pursued) will be limited by the low-risk ability of competitors to appropriate the result for themselves – if it should succeed. Of course, attempts at invention, research and development also fail, and the cost of failure must also be recouped from the attempts that work. Is there no opportunity for LEC innovation under these terms? This we cannot say, for the relatively inexpensive (or the low-risk) effort might still pay off, since the LEC may retain the ability to

capture some gains even under these terms. But clearly, the unbundling and resale requirements render the profit incentive offered to an LEC vastly inferior to that which is offered to other firms and industries in our economy, as well as to the LECs' competitors in the same industry.

Indeed, the contrast is striking. For most firms and industries, a hierarchy of legal protections protect the right of companies to profit from their innovative efforts, even to the point of creating an artificial monopoly for the better part of a generation through a patent. For instance, public policy has long encouraged innovation in the United States, beginning with the Constitution's specific grant of authority to Congress to write patent and trademark laws:

> "The Congress shall have power...[T]o promote the progress of science and useful arts, by securing for limited times to authors and inventors the exclusive right to their respective writings and discoveries..." (Article I, section 8)

Of course, the common sense reason for patents is to provide incentives to those who would create useful inventions or innovations, incurring expense and risk in the process. While a patent does permit an inventor to earn monopoly profits for a defined period, those buying the patented product gain through using an innovation they otherwise might not have obtained.

Other public policy also protects innovations, to varying degrees. Copyrights provide long-lasting exclusivity to creators of literary or artistic works. Exclusive trademarks or servicemarks protect investments in brands and related defining characteristics of how a product or service is provided. Firms can also protect sources of competitive advantage as trade secrets, or through non-disclosure contracts courts will enforce. And even absent any of these specific legal protections, firms ordinarily have no affirmative duty to disclose or share particular sources of competitive advantage they may develop, including innovations in products or processes.

The law also meshes well with the teachings of economic theory and research. While the study of innovation is a huge subject encompassing many topics, across this literature the need is unquestioned for innovators to capture (or "appropriate") at least a portion of the benefits from

their successful efforts, in order to encourage innovators to put forth the effort and assume the risks. Nor is there any doubt about the importance of innovation to the American economy, where the majority of the measured improvement in the standard of living in this century has come from "the application of new, superior production techniques by an increasingly skilled work force."[3] The role of large firms or monopolies in innovation has also been long debated, without a definite answer; some evidence and theory points to highly concentrated industries as more innovative, while other evidence and theory points the opposite way. However, in summarizing this literature, Scherer and Ross conclude,

> "What is needed for rapid technical progress is a subtle blend of competition and monopoly, with more emphasis in general on the former than the latter, and with the role of monopolistic elements diminishing when rich technological opportunities exist."[4]

These ideal conditions sound very much like today's telephone industry, where both established, large players and innovative newcomers have opportunities and a role to play. Certainly, the economic literature – much less the history of the telephone industry itself, starting with Bell Labs – stands firmly against any claim that firms like incumbent LECs have nothing to offer by way of innovation. Therefore, any public policy that substantially limits the incentives of LECs to innovate is inherently suspect. Under the FCC's Section 706 approach, however, an LEC's *competitors* are given the right to appropriate the gains from any local telephone company innovation that proves successful -- *which turns the entire logic of patent protection on its head.* As a result, local telephone companies are effectively being told not to bother with efforts to develop any but the most certain, or costless of new technologies and products, even while Congress has singled out advanced services as requiring special efforts for promotion by the FCC.

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[3] Scherer, F.M. and David Ross. Industrial Market Structure and Economic Performance (3rd Ed., Houghton Mifflin Company, Boston, 1990), pages 613-614. See, generally, chapter 17 for a review of the economic literature on market structure, patents and innovation.

[4] *Id.*, at 660.

As a reality check on these concerns, we need look no farther than the recent comments of AT&T Chairman C. Michael Armstrong, whose firm is attempting to acquire the cable television giant TCI – including its unique, broadband connections to tens of millions of households. TCI's facilities provide the perfect base for offering many advanced services; however, other concerned parties have asked that AT&T–TCI be required to comply with unbundling requirements that would also permit competitors access to those facilities. Mr. Armstrong's response was quoted as follows:

> Mr. Armstrong said that the post-merger AT&T–TCI will be spending close to $2 billion to upgrade TCI's network to enable the company to offer a bevy of high-speed broadband services, such as Internet access and Internet protocol-based local telephone service. Other telecom companies should not be given a "free ride" on that investment, Mr. Armstrong said. That could dry up financial resources AT&T–TCI will need to complete their plan and also hinder competition, he warned. "No company will invest billions of dollars to become a facilities-based broadband services provider if competitors who have not invested a penny of capital, nor taken an ounce of risk, can come along and get a free ride on the investments and risks of others," Mr. Armstrong said. [5]

For the first time since the Act, its acquisition of TCI forces AT&T to face the potential consequences of a regulatory regime like the FCC proposes for the identical offerings of LECs (who, not incidentally, will presumably no longer have any advanced services "bottleneck" to speak of in locations where AT&T completes its planned network upgrades of TCI's plant). Not surprisingly, Mr. Armstrong's analysis of the resulting harm mirrors our own.

4. Regulatory Concerns and the Separate Subsidiary

Of course, proponents of the FCC's proposal might object to our analysis, offering reasons such as the following:

- First, that LECs are not especially innovative, and that their related efforts might be little missed;

[5] TR DAILY, November 2, 1998, page 2.

• Second, that the risks of LEC provision of new services are high, because LECs will thereby leverage local service monopolies into competitive markets for advanced services, to the detriment of competition and captive customers (who might be forced to pay cross-subsidies to fund such efforts);

• Third, that LECs can just as well innovate through a separate subsidiary, since there is little about advanced services that would benefit from sharing the existing LEC network, or the LEC's operational support and marketing functions;

• Fourth, that regardless of federal regulatory efforts, state authorities will extend a blanket of regulation over any advanced service that is integrated with the LEC (including resale and unbundling requirements), so freedom from federal regulation would be largely symbolic;

• Finally, that other regulatory constraints on LECs (such as rate of return regulation, or implicit ceilings on earnings) might themselves dull incentives to such an extent that any Section 706 initiative is effectively irrelevant.

We believe there is an appropriate response to each of these concerns.

A. If Permitted, LECs Will Produce Innovations

First, notwithstanding their status as once-monopolies, we have seen LECs improve their networks, reduce their costs, introduce and successfully market new products, and generally maintain a telephone system that we believe remains the envy of the world. We have no doubt that competition is preferable to monopoly, and that any large organization or business may have opportunities to improve. At the same time, we believe the evidence shows that worthwhile contributions can be expected from the nation's incumbent local telephone companies in the areas of innovation and deployment of advanced services. Indeed, the economics literature to which we referred also recognizes the potential shortcomings of highly-concentrated industries, or even monopolies; yet in fact (as theory allows), such industries have been the source of important innovations, including all that the Bell System produced as part of the foundation of modern telecommunications.

Other infrastructure providers – such as cable television companies – also have ubiquitous networks that can be capable of offering advanced services such as high-speed Internet access. For example, cable modems can offer much higher rate Internet access than the dial-up modems now typically used for Internet access over LEC loops. Indeed, in many instances another infrastructure company that is not handicapped by LEC-type regulation may be positioned to become a dominant provider, to the disadvantage of customers if LECs are hampered by regulation in their ability to respond.

While it is not possible to make a specific prediction as to the improvements to advanced services that LECs will make if unencumbered by regulation, we believe that public policy must recognize the likelihood that these major market participants will contribute, if allowed appropriate incentives to do so by regulation.

B. Existing Regulations and Incentives Already Address Concerns About Cross-Subsidy and Foreclosure of Access

Second is the issue of inappropriate conduct and cross-subsidy, or the assertion that gains from LEC participation will be exceeded by harms they will perpetrate on the market, and customers. Among many, it has seemingly become an article of faith that such abuses will occur, as evidenced by the knee jerk reactions from some competitors that decry any regulatory flexibility proposed for LECs. Such reactions also lead to a political dynamic that may be evident in the FCC's Section 706 proposals, whereby "concessions" to LECs are "balanced" by placing further limitations on LECs at the same time. In effect, the new proposed limitations reveal a puzzling inconsistency on the FCC's behalf regarding the existing oversight rules for LECs – which the agency has previously found to be adequate to the task.

The specific concerns with the market position of an LEC are cross-subsidy and foreclosure of access to unique facilities (or the network generally) needed by competitors to LECs. These are now decades-old concerns, with remedies that in many cases stretch back at least as far.

As for *cross-subsidy*, what is usually expressed is a fear that residential customers or interexchange carriers will overpay (for basic telephone service or carrier access, respectively) to support LEC incursions into new markets. However, since most LEC basic residential rates are still subsidized (or perhaps barely covering their incremental cost), describing them as a possible ***source*** of cross-subsidy is fanciful at best. Where LECs might increase basic rates, regulatory approval is still required, and almost always involves a highly contentious, public proceeding expressly aimed at preventing such cross-subsidy. For their part, while access charges still include a contribution (which is substantial in most jurisdictions), the undeniable trend of access charges is down, making increases for any purpose (including funding a new cross-subsidy) almost inconceivable. Further, state regulators and the FCC have rapidly adopted incremental cost analysis and modeling as the preferred approach to calculate service costs, which is a further safeguard against LECs sneaking improper costs into the equation. Nor do the majority of states or the FCC set large telephone company prices through rate cases any longer (or even through earnings "sharing" formulas); and the absence of rate-of-return regulation removes the means and the incentive for misallocation of costs – since the presumed motive for such efforts was to shift costs into regulated books of account (or between customer classes within regulated accounts) to increase the next earnings-based rate award from a regulatory commission. Of course, when prices are no longer set through a rate-of-return mechanism, this motive evaporates, as the Commission well knows. Finally, extensive federal and state accounting requirements and safeguards are targeted at misallocation of costs per se (even short of an actual cross-subsidy). Thus, we see no viable incentive or mechanism by which an LEC could perpetrate an improper cross-subsidy related to new advanced services.

We see three separate questions about potential *foreclosure of access*, which raise progressively diminishing public policy concerns:

- Ensuring interconnection between the networks of LECs and those of new competitors;

- Allowing competitors to make use of essential LEC facilities that could not reasonably be duplicated by a competitor;

- Requiring LECs to unbundle facilities or capabilities that may not be essential, but which competitors would find convenient.

For its part, the Telecommunications Act of 1996 requires that LECs provide interconnection to competitors, and also that they unbundle certain "network elements" for the use of competitors, and offer all "telecommunications services" for resale by competitors. In its Section 706 rulings, the FCC applied these provisions expansively, to fully encompass advanced services offered by LECs.

What are we to make of these expansive requirements? We think the FCC has gone too far, and has failed to draw the critical line between interconnection and unbundling of *essential* facilities and services, versus unbundling of *all* facilities and services.

As regards the first question, we believe the case for regulating interconnection between networks is clear, including a role for regulation if competing networks cannot agree on terms. The larger the number of customers who can reach one another, the more valuable is the assemblage of networks -- and this benefit also extends beyond the owners of any two networks that may be negotiating interconnection at a given time. This broader impact of any given LEC–competitor negotiation is a key distinguishing element of this concern, as is the fact that a competitor may have no ability to substitute anything else in place of interconnection with a given LEC. And requiring two network providers to interconnect does not necessarily deprive either provider of any innovation gains or profits it may obtain from offering advanced services to customers. We think the case for some kind of regulatory backstop is clearest here.

The second question involves unbundling of unique or "essential" facilities – those owned only by the LEC, not reasonably duplicable by competitors, and necessary to provide some kinds of service. Whether a particular facility fits this description is an empirical question that depends

upon whether viable alternatives are or could reasonably be available. For example, a local loop to a residential customer might be called essential if no other comparable facilities now reach that customer, although (for example) the availability of cable modems or wireless loops in a neighborhood would change that analysis.[6] Where a facility truly is essential, the case for allowing access to it at a fair price is clear.

Finally, the case is weakest – or, more precisely, nonexistent – for mandated unbundling of facilities that competitors already have or could readily duplicate or acquire for themselves. Indeed, the critical task for regulators is to distinguish carefully between those facilities that truly are essential and those that are not. The damage that would result from excessive unbundling is severe. Here, there is no externality, nor any LEC market power. Such a policy has not, to our knowledge, been applied to any other industry. When competitors can obtain facilities from multiple sources, there is no argument for mandatory resale or unbundling of embedded LEC plant.

For its part, the FCC has said yes to regulating all three levels with respect to advanced services and LECs – yes to regulating interconnection, yes to regulating unbundling of essential facilities, and yes to regulating unbundling and/or resale of all other LEC advanced services and related network elements. Even though the public policy justification for government involvement disappears as we move from interconnection and facilities that are genuinely essential to those that are not, the FCC has chosen to draw no line – but instead to apply the entire panoply of wholesale regulation, including its burdens on innovation, to all LEC investments, facilities and services.

[6] As noted above, the merger of AT&T and TCI will produce a competitor that is well-positioned to provide advanced services entirely apart from LEC facilities.

C. The Impaired Separate Subsidiary

As an alternative to applying full unbundling and resale requirements to LEC advanced services, the FCC has offered an option of creating a fully separated subsidiary to offer such services without those requirements. The FCC has also said that this subsidiary would be subject to new, additional affiliate transaction and separation requirements. Thus, existing LEC separate subsidiaries (such as GTE's long distance operations) would appear to be drawn under the new rules if they are to offer advanced services. The FCC has trumpeted this new subsidiary as a viable means for LECs to offer advanced services relatively free from regulation, perhaps even through a new network of the future. Of course, the usual suspects have also weighed in to decry the proposal as an unjustified capitulation to LEC interests.

In essence, this FCC proposal would permit LEC holding companies to provide advanced services under a kind of portfolio diversification, involving the creation of new business units that would have virtually nothing to do with the LEC's own operations. Indeed, as GTE has identified in its formal comments to the FCC, this new subsidiary would gain no apparent advantage from its association with the LEC, while also being placed in a worse position in its business dealings with the LEC than are the advanced services operations of competing carriers.

The question is what, if anything, this separate subsidiary proposal is likely to add to the advanced services market for the benefit of customers. From a public interest perspective, the new subsidiary would benefit customers only where it can add something that existing avenues for advanced services cannot. This question involves a tradeoff between (1) the gains to the new advanced services subsidiary from whatever association it is allowed to have with the LEC, versus (2) the business disadvantages and regulatory burdens imposed by the FCC's intensified affiliate transactions and separation requirements. Looking at the benefits side, all that's really in this for the new subsidiary is a potential source of equity funding, and the opportunity to share a common name with the LEC or its holding company. Any sharing of tangible assets, operations, or support services with the LEC is prohibited. On the costs and burdens side, the FCC's

proposals clearly raise the affiliate's cost of doing business with the LEC relative to what non-affiliates would incur for similar dealings. On balance, we believe the new subsidiary would lose more than it would gain, by comparison to the business standing of an unaffiliated advanced services operation.

To put this another way, consider a hypothetical investor considering an equity investment in an advanced services operation; his choice is between advanced services offered by a large, vertically integrated non-LEC, or a new subsidiary having a common parent with the LEC to be established under the FCC's proposed rules. We believe the investor would find the non-LEC operation more attractive; and if that is so, then *there is no benefit for customers or the economy in the FCC's proposal, since its new avenue would be clearly inferior to other opportunities that already exist to provide these services.*

The bottom line is that the only advantage of the FCC's proposal may be to permit the holding company to serve as a potential source of capital for funding the entry of a separate operation into a business in which many other firms already compete. Of course, there is no shortage of capital available for such purposes, and the cost of what the holding company might provide to its subsidiary would be no different than the cost of capital supplied from other sources for the same undertaking. Thus, there may be little that is special about permitting the separate subsidiary to offer advanced services under conditions that permit the use of holding company funding, but none of the other potential advantages LECs might bring to the effort. Indeed, the FCC's proposal is designed specifically to frustrate any such advantages, or joint efficiencies.

Finally, even putting the LEC aside, by creating special new restrictions on such an advanced services affiliate even by comparison to existing FCC affiliate separation requirements, the *Order* and *NPRM* could frustrate the achievement of joint efficiencies even with an LEC's existing subsidiaries and affiliates. We return to that issue below in addressing GTE's proposal in this proceeding.

D. Escaping the Briar Patch of LEC Regulation

A further argument for the FCC's proposal might be that any advanced services offered by LECs would inevitably fall under state jurisdiction, at least in part, and thus be regulated intensively regardless of the FCC's actions in the federal jurisdiction. Therefore, the FCC's proposal has offered LECs an avenue to avoid not just federal, but also state regulation by establishing a new advanced services subsidiary.

At this stage in the post-Act development of the industry, there is certainly some wisdom in observing that the path to any kind of deregulation of LECs (a goal envisioned by Congress) seems more remote than ever. The apparent desire for control and involvement on the part of regulatory agencies seems to reinforce the continual use of the regulatory process by competitors of all stripes to hamstring each other, or merely seek advantage through regulatory actions that may have been undertaken for some other purpose, but which cannot help but influence the relative competitive positions of numerous firms. Informed industry observers know that the "deregulation" that is reported in the popular press is a myth.

Notwithstanding this, we do not see the FCC's proposal as helping matters towards deregulation. Certainly the FCC has authority in the Act to preempt state regulation where appropriate, and the advancement of the explicit goals of Section 706 would seem to provide such grounds. If state regulation is the real problem, the FCC should try to preempt it directly rather than trying to force advanced services into a subsidiary -- which will probably require the protection of FCC preemption in any event if it is to stay free from state-level regulation.

Indeed, rather than protect LEC advanced services operations from problems caused by state regulation, the FCC's broad interpretation of unbundling and resale obligations is likely to prove a self-fulfilling perpetuation of that process. The prospects for competition and deregulation are harmed by mandatory unbundling and resale at government-set prices, if for no other reason than government is very unlikely to get those prices "right" – that is, set at levels equal to what a

competitive market would provide. Given the variety of network elements and services involved, and the varying cost and demand characteristics in play across markets, customers and geography, it is difficult to believe that government will even get some prices correct. This is not due to any lack of intelligence or effort in the attempt -- it is simply a truism of economics that government cannot substitute its centralized judgment for that of a market without causing substantial (even if inadvertent) distortions.

The problems that follow from wrong wholesale prices are easily seen. Competitors can make or buy their facilities, including from the ubiquitous LEC. Where government-mandated prices rise above market levels, they are of no consequence for the market -- entrants will either build facilities, or LECs will voluntarily offer wholesale prices below the regulatory ceiling. Where government-mandated prices fall below market levels, the make or buy decision is tilted towards purchasing LEC facilities at wholesale, thereby suppressing facilities-based competition. Even though other factors come into play (such as preferences for end-to-end control, avoiding regulatory risk, or minimizing sunk costs that might be stranded), below-market prices for LEC wholesale offerings must chill facilities-based competition.

Below-market prices for LEC wholesale services and facilities also create quasi-rents (or positions of privilege) for those competitors that purchase them. Under these circumstances, there is always a winner and a loser when an LEC and a competitor sign a contract; of course, normal business dealings proceed when both parties see advantages from a contract. Mandatory "win-lose" contracts are an obvious spawning ground for disputes that regulatory agencies will be called upon to resolve – leading to permanent regulatory involvement for as long as such contracts may be required.

Thus, below-market LEC wholesale prices create a virtual formula for perpetual regulation – on the one hand, a proliferation of forced contracts each involving one firm that gains at the other's expense, while on the other hand, potential alternative sources of supply are suppressed by low, regulated wholesale prices. If the presence of facilities-based competition is to be the test for

deregulation (as it seems to have become), then these circumstances offer no exit strategy for regulation.

Putting LEC advanced services under the same full regulatory umbrella as other LEC facilities and offerings will not advance the prospects for deregulation, and may well impair them.

E. The Impact of Other LEC Regulation

Finally, it may be argued that the choice of regulatory approaches to advanced services is of little consequence, since other regulation already greatly chills LEC incentives to innovate. In particular, the incentive problems of rate-of-return regulation are well known -- including the possibility that what LECs might gain from selling advanced services might thereafter be taken away in a rate case.

However, as of this writing alternatives to rate-of-return regulation are in use for large telephone companies in a clear majority of states, and at the federal level.[7] Even where rate-of-return regulation continues, competitive pressures facing local telephone companies may combine with the influence of regulatory lag to mitigate the effects of rate-of-return regulation, and thus preserve some of the payback to LECs from innovation.

Still, where the lingering impacts of rate-of-return regulation are a concern, the FCC should take advantage of the language of Section 706 and mandate that price caps (without earnings sharing) be used for any price regulation of advanced services at the state level, to preserve beneficial incentives. Better yet, the FCC should simply preempt such state regulation.

5. Conclusion: Two Proposals, and The Need for FCC Leadership

[7] "Status of Alternative Local Telco Regulation in the East," "Status of Alternative Local Telco Regulation in the West," State Telephone Regulation Report Vol. 15, Nos. 6-7 (March 20 & April 3, 1997); "Earnings Regulation For Big Incumbent Telcos Just About Extinct in Eastern U.S.," State Telephone Regulation Report Vol.16, No.7 (April 3, 1998).

As we have explored in this white paper, the FCC has essentially made a judgment call that the gains from integration of advanced services into LEC networks and/or operations are less than the chance that LECs would be able to use that integration as a source of anticompetitive leverage. Further, the FCC continues to appear comfortable with a highly regulatory approach to these questions that does not appear to contain an exit strategy for regulation; indeed, the opposite may be occurring as regulation becomes even more entrenched and self-sustaining. Not surprisingly, the current politics of LEC regulation also appear to play a role in the FCC's actions.

What are the alternatives? We would highlight two.

First, as was already implied by our analysis, a viable long-term approach to regulation of LECs should be minimalist and founded in genuine market failures, or comparable problems suited to a permanent regulatory solution. Further, as Congress stated in the Act, the FCC should hedge its bets on the side of competition and deregulation, not on the side of monopoly and regulation as it is doing today. As we have described, the centralized governmental regulation of unbundling and resale is self-fulfilling if the criteria for deregulation is the development of facilities-based competition, since that regulation will inevitably chill competition.

These criteria point towards the least possible regulation of unbundling and resale, since that will provide the most possible latitude for competition and deregulation. How can the FCC accomplish this? Generally speaking, the regulation of wholesale pricing (especially unbundling) should be limited to those facilities that are in fact essential in today's market, as we described earlier, and should otherwise leave LECs and their competition free to make whatever voluntary arrangements they may prefer for other wholesale transactions. Additionally, the FCC should recognize that regulated wholesale prices will inevitably be set incorrectly by regulatory decisions, and that the mistake the FCC should most want to avoid (in a pro-competitive approach) is prices set so low that they prevent competitive entry. Therefore, whatever prices

result from the current "combat-by-engineering-and-economic-models" of TELRIC brought about by the dictates of the FCC (as Alfred Kahn has aptly characterized the process) should gradually be increased to permit competition to develop based on appropriate price signals. If, in time, we discover that competition is infeasible for certain facilities or network elements for which there are still no realistic alternatives, it may eventually become necessary to re-regulate them as monopolies, as a last resort. But the FCC should first give competition a chance through regulatory forbearance.

Of course, this approach would include no wholesale regulation of LEC advanced services, since there is nothing "essential" about these new offerings. Likewise, LECs should be permitted to pursue the full benefits of integrating advanced services with their existing operations, since price caps and other protections against cross-subsidy will keep other prices from rising to fund such efforts. And while competitors to the LECs have a reasonable claim to regulated unbundling of *essential* LEC facilities, there is no justification for regulating the wholesale prices of other LEC services and facilities competitors can readily create for themselves. This pro-competitive, de-regulatory approach to advanced services will permit customers to obtain the benefits of integration, whatever those may be.

Second, we recommend GTE's National Advanced Services Plan if the FCC will not adopt an approach such as we have described. The GTE Plan represents a compromise with respect to the political pressures to which the FCC seem to be responding, while permitting some ability for LECs to obtain benefits from integration (albeit only with other subsidiary operations – not with the LEC). Further, GTE's Plan offers a one-time opportunity for LECs to transfer advanced services operations to a subsidiary free of regulatory burden or penalty, which would be a wise policy to avoid penalizing innovative efforts that LECs may have undertaken thus far. Neither is there any demonstrated need to adopt the more stringent separation requirements the FCC has proposed for an advanced services subsidiary, in the absence of any showing of harm or unworkability of the FCC's existing rules. The politics of LEC regulation are, in this case, a poor guide to informed policy, and the proposed harsher affiliate relationship rules seem to have

no other basis.

Finally, we would issue a call for leadership to the FCC. Obviously, the implementation of the 1996 Act has become something of a pro-regulatory muddle, and we suspect that most who were involved in its enactment hoped for more in terms of competition and deregulation by this stage. Much of the blame for these circumstances must be laid at the feet of regulatory agencies that have rhetorically embraced competition but continually hedged their bets by adopting intensively regulatory approaches to implementing the 1996 Act. As we have described here, such regulation can easily stifle competition and become self-perpetuating. Granted, there is uncertainty on every side of this debate, and particular results cannot be guaranteed -- but it is time for the FCC to cast its lot with the side of competition, rather than regulation, and this Section 706 proceeding provides the perfect opportunity to do so.